Testimony of Anthony B. Sanders
Judiciary Committee, U.S. Senate
Washington, D.C.
February 1, 2011

Mr. Chairman and Members of the Committee:

My name is Anthony B. Sanders. I am Professor of Finance, Distinguished Professor of Real Estate Finance and Senior Scholar at the Mercatus Center at George Mason University. My research focuses on real estate finance, securitization and housing economics.

Thank you for the invitation to testify before you today.

**Declining House Prices, Unemployment Make Loan Modifications Very Difficult**

When President Obama was elected in November 2008, the Case and Shiller Composite-10 index was 165.95, down from its peak in June 2006 of 226.29. The unemployment rate in November 2008 was 6.5%, up from 4.8% at the peak of the housing bubble in June 2006. According to the most recent releases, the Case Shiller index has declined further to 157.28 (November 2010) while unemployment has risen to 9.1% (December 2010). [See Figure 1]

While housing and unemployment numbers are disturbing at a national level, they are far worse in many states. House prices a haven fallen substantially in the “sand states” of Florida, Arizona, Nevada and California (each over 40% from peak to recent). Other states such as Rhode Island, Maryland and Michigan have experienced a decline of over 20% in house prices [See Figure 2]. In terms of unemployment, Nevada, California and Florida have unemployment rates far higher than the national average of 9.1%. [See Figure 3]

Thus, until unemployment starts to shrink dramatically and housing prices began a serious recovery, successful loan modifications will be very difficult to achieve.[1] The forecast for unemployment is not positive, so difficulties in loan modifications are likely to continue. [See Figure 4]

**Government Intervention in Loan Modifications**

The Obama Administration announced the Making Home Affordable (“MHA”) program on February 18, 2009 shortly after President Obama was sworn into office. The goal to help as many as three to four million financially struggling homeowners avoid foreclosure by modifying loans to a level that is affordable for borrowers now and sustainable over the long term. $45.6 billion was allocated to support MHA.

[1] The private market is facing similar headwinds.

Between the GSEs and the Non-GSEs, a total 1,466,488 of loan modifications were started.[2] As of December 31, 2010, a total of 734,509 trials were cancelled with 673,919 mortgages were still undergoing modification, either permanently or on a trial basis. Of those, 521,630 were active permanent modifications and 152,289 were active trial modifications in limbo. In other words, the active permanent modifications to trials started are only 35.6%. These numbers are far lower than the original goal of 3-4 million loan modifications. If we compare the number of successful permanent modifications as a percent of the funds that have been allocated, the cost of each loan permanently modified is $87,418.28 per loan.[3]

As I mentioned previously, the collapse of housing prices and high, sustained unemployment makes it very difficult for Home Affordable Modification program (HAMP) to be successful. When you add the investors and mortgage insurers to the mix, the servicer may be conflicted in terms of offering a loan modification or the terms of the modification that please everyone (or anyone).

Clearly, the HAMP program has been a very costly program that has achieved relatively few loan modifications resulting in permanent foreclosure avoidance. Since the goal of home preservation (where loan modifications are used to keep borrowers in their home) may be the inappropriate objective, perhaps it is time to consider other alternatives.

**Alternatives to HAMP and HAMP-related Programs**

A number of alternative proposals to HAMP and voluntary, privately initiated current servicer programs for loan modification have been proposed. They range from dramatic principal reductions (e.g, Hubbard and Mayer[4]) to loan modifications for the unemployed.

Whatever proposal Congress pursues, it will be a steep hill to climb. Lenders filed 3.8 million foreclosures in 2010 and even more are expected to be filed in 2011. It is projected that the foreclosure wave will subside in 2012, but not before several million foreclosure notices have been filed. And we can only hope that house prices have started rising again in 2012 and unemployment begins to decrease.

The Hubbard-Mayer proposal highlights the difficult of a government solution to the problem. Essentially, Hubbard and Mayer advocate having Fannie Mae and Freddie Mae reduce borrower loan principal through refinancing on mortgages they insure or hold. The borrower's principal would be reduced to local house price levels, thus negating the negative equity problem and partial income curtailment problems.

---

[2] http://www.sigtarp.gov/reports/congress/2011/January2011_Quarterly_Report_to_Congress.pdf

[3] This is not the "true" cost per loan, simply a representation of the cost of HAMP given that permanent modifications have been extremely modest.

[4] http://www.nytimes.com/2010/09/19/opinion/19hubbard.html?_r=2&adxnnl=1&ref=opinion&pagewanted=1&adxnnlx=1284899990-ve6qTvd4bPS5vlT0vokRsQ

“Would the refinancing program increase the federal budget deficit? No. In fact, the change will probably reduce the federal deficit in the long term. Taxpayers are already on the hook for hundreds of billions of dollars of likely losses from loan guarantees to Fannie Mae and the other agencies. If we can lower mortgage payments for struggling homeowners, it will reduce future foreclosures on federally backed loans, providing savings to taxpayers.” Source: Hubbard and Mayer, New York Times, 09/19/2010.[5]

While it is true that their plan would lower mortgage payments and may reduce future foreclosures, the costs are staggering (not free). Someone has to bear the losses of the principal reductions and interest rate reductions. Fannie and Freddie bondholders would have to accept lower interest payments and suffer large declines in bond value (also known as a haircut). In addition, Fannie and Freddie cannot cast a magic spell and decree that borrowers have to refinance their mortgages; borrowers would have to go through the refinancing process. Finally, the bondholders purchased these bonds without any understanding that the government would step in and reduce their value.

Stepping into markets with “ex-post contracting” is dangerous because it sends a signal to the global community that the government cannot be trusted to deliver what was promised. The problem, of course, is that the best intended government attempt to fix the crisis may not work, leaving investors (such as China, pension funds, insurance companies, etc) with a jaundiced eye about U.S. debt, whether Fannie/Freddie debt or national debt. Of course, this eventually leads to higher interest rates and a lower demand for our debt securities, further destabilizing the American economy and preventing economic recovery.

As I have testified before, we need to restore confidence in the securities markets, not surprise and anger the markets.

**Bankruptcy Court and Loan Modifications**

One of the objectives of government loan modification programs is home preservation. Home preservation is achieved when loan modifications are used to keep borrowers in their home. The desire to keep borrowers in their home must make economic sense to both the investor and servicer.

There is a movement to provide homeowner relief by allowing bankruptcy courts to force the borrower and servicer to into attempting to mediate a solution. The servicer would be required to make a good faith effort at offering a loan modification; whether good faith requires the servicer to be willing to modify the loan may be an open question under this legislation.

We already have HAMP and individual lender/servicer programs in place; do we really want yet another variation of HAMP (through bankruptcy courts)? While legislation

[5] http://www.nytimes.com/2010/09/19/opinion/19hubbard.html?_r=2&adxnnl=1&ref=opinion&pagewanted=1&adxnnlx=1284899990-ve6qTvd4bPS5vlT0vokRsQ

mandating mediation between the parties sounds benign, there are several serious problems with this approach to the loan modification problem.

First, having a mandatory mediation assumes that a borrower would be better-off in their home as an owner than as a renter. Given the prevalence of negative equity and the large supply of vacant and rentable property in the country, it is highly likely that many borrowers would be better off renting. Homeownership is expensive and not for everyone since it has always been a risky investment.[6] Just based on tax reasons, many households are in a very low marginal tax rate already; hence, the interest and property tax deduction is thrown away or valued at a low rate. Renting is more efficient in terms of taxation. When you combine the tax disincentives with the risk of homeownership, borrowers would often be better-off renting and getting a fresh start.

As Raphael Bostic, HUD's Assistant Secretary for Policy Development and Research, stated in a recent Washington Post interview,[7]

"In previous eras, we haven't seen people question whether homeownership was the right decision. It was just assumed that's where you want to go. You're not going to hear us say that."

Second, a mandatory mediation adds additional costs and delays to the process, a process that is already severely strained. The average time to liquidation of a house averages 17 months already (costing the investor/lender lost interest and asset value declines). If bankruptcy becomes more appealing to borrowers because of the mandatory mediation, we would expect rather onerous delays in moving borrowers to foreclosure. Furthermore, the mandatory modification may result in borrowers bypassing HAMP (or lender/servicer programs) and go directly into bankruptcy.

Third, Fannie Mae and Freddie Mac, the mortgage giants, have expansive data bases and models regarding the likelihood of a borrower surviving with a loan modification. If Fannie Mae and Freddie Mac are having trouble with serious delinquencies and foreclosures, what are the odds that a bankruptcy court can intervene with a sensible loan modification solution that Fannie/Freddie couldn't direct its servicers to accomplish?

Fourth, any requirement of mediation between a borrower and the servicer must be made explicit when the mortgage loan is originated and the securities are created. As of now, there is no understanding by borrowers or investors that mandatory mediation in bankruptcy is required, or that it is even possible. This represents another "surprise" to investors and other market participants which is almost always viewed negatively. Creating more surprises may further decrease interest in mortgage-market investment, resulting in less available mortgage credit and higher interest rates.

[6] I was quoted in the New York Times in 1988 concerning Governor Dukakis' proposal concerning getting more lower income households into homeownership: "Ask investors in Houston how they would have liked it if they'd been stimulated to buy housing," Professor Sanders said, referring to the housing crash in Texas.
[7] http://www.washingtonpost.com/wp-dyn/content/article/2010/07/20/AR2010072005946.html

Finally, while mediation may result in more loan modifications being made, we know that the failure rate on loan modifications is about 50%. And this could be higher if house prices continue to be soft and unemployment doesn’t improve. Stated differently, if the standards for getting a loan modification are lowered, the more likely it is that the failure rate for loan modifications would increase.

In summary, the housing market needs to recover and persistent attempts at delaying foreclosure (whether through mediation or moratorium) only adds additional uncertainty to the housing market and slows any recovery.

I suggest that lenders/servicers continue their efforts to offer sensible loan modification programs. Mediation in Chapter 13 could cannibalize HAMP and private market attempts at loan modifications. And we need to reconsider that policy of keeping borrowers in their homes if it does not make economic sense to any of the parties involved.

Thank you for your willingness to let me share my thoughts with you.

Figure 1. S&P/Case-Shiller Home Price Indices as of November, 2010.

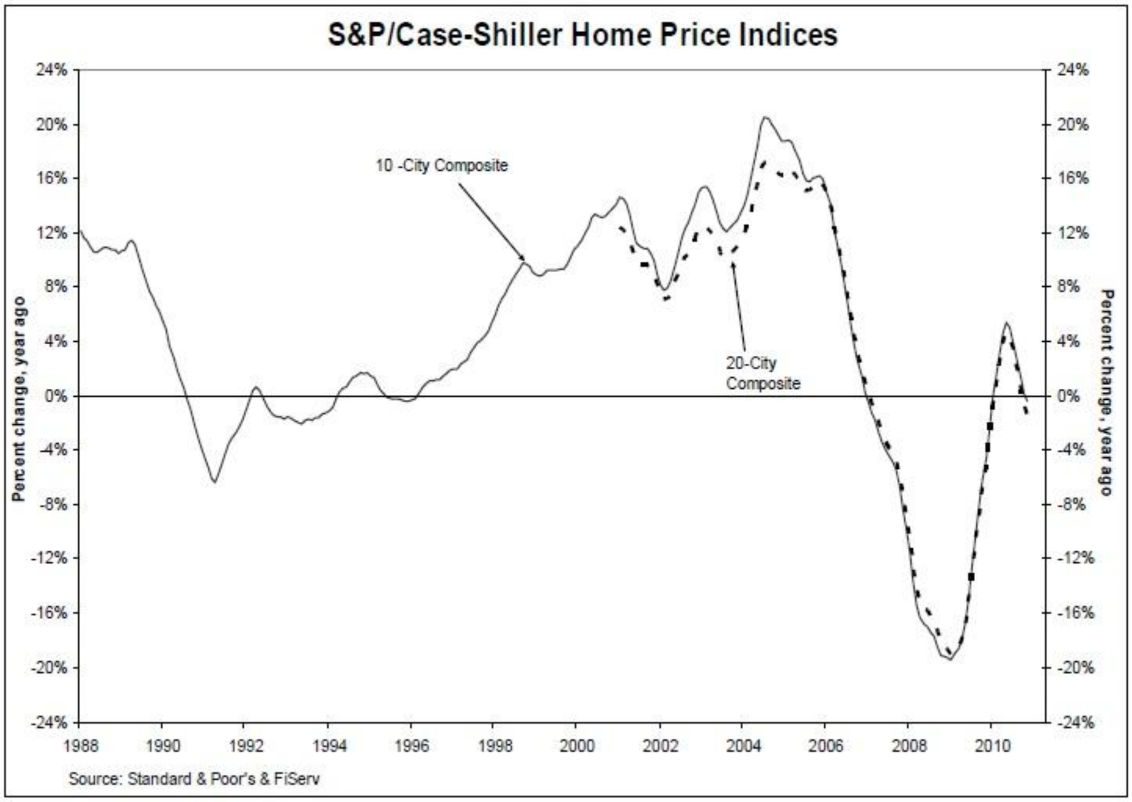
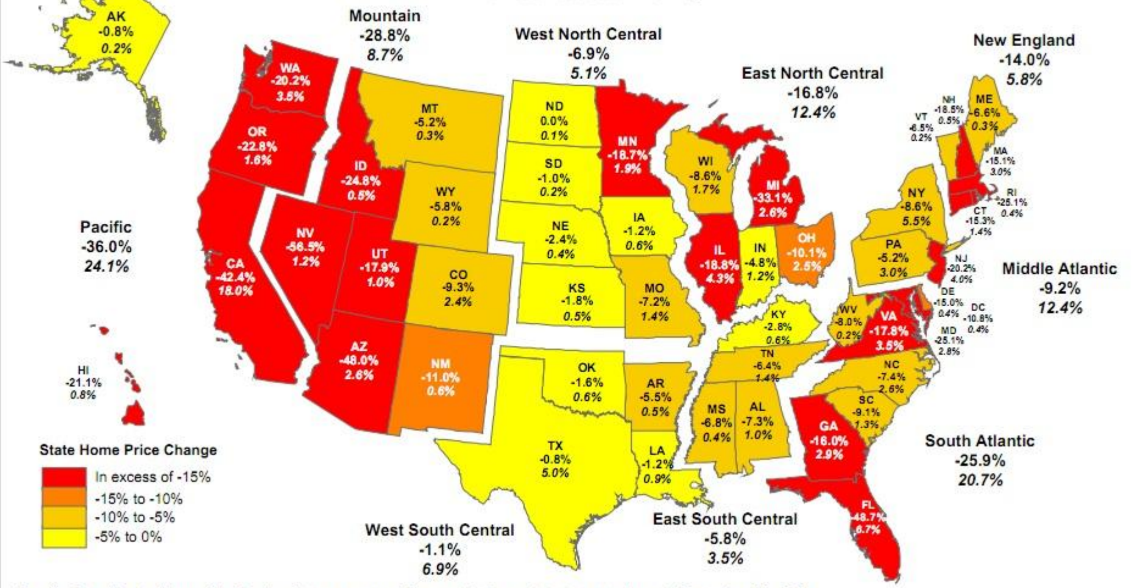



Figure 2. Peak-to-current house price declines illustrating the difficulty in performing loan modifications in states where house prices have declined more than 15% (red).

## Home Price Declines Peak-to-Current (by State) as of 2010 Q3

United States -18.1%




Top %: State/Region Home Price Decline Rate percentage from applicable peak in that state through September 30, 2010
Bottom %: Percent of Fannie Mae single-family conventional guaranty book of business by unpaid principal balance as of September 30, 2010

Note: Regional home price decline percentages are a housing stock unit-weighted average of home price decline percentages of states within each region.

Initial estimate based on purchase transactions in Fannie-Freddie acquisition and public deed data available through the end of September 2010, supplemented by preliminary data available for purchase transactions to be closed in October and November 2010. Including subsequently available data may lead to materially different results.

Figure 3. Unemployment rates in the U.S. and Nevada, California and Florida.

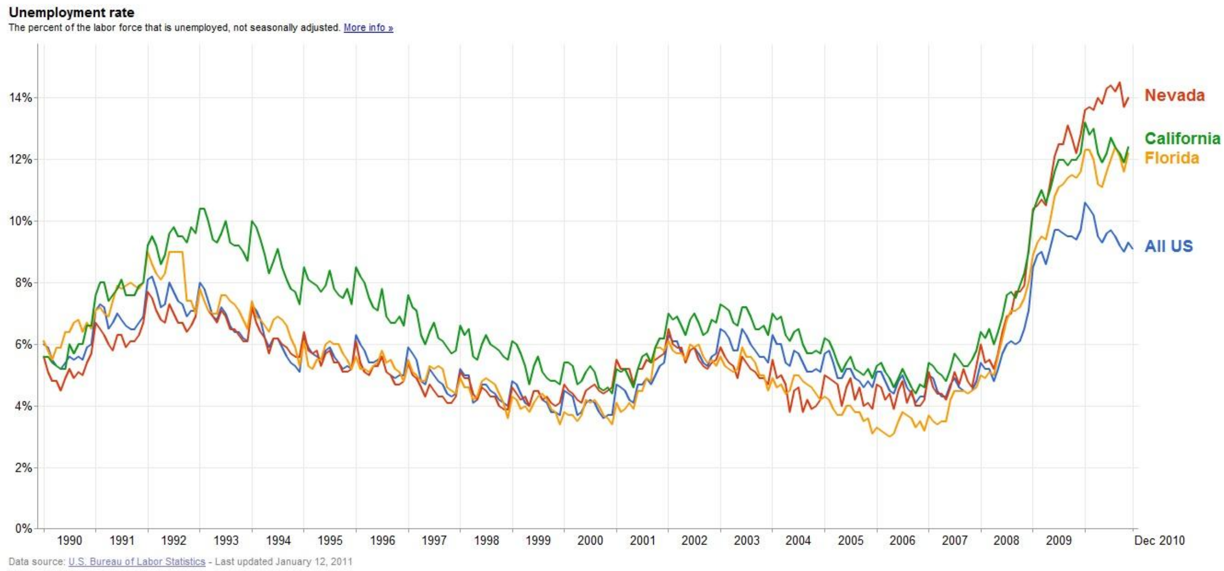


Figure 4. Unemployment is very slow to recover after the last recession making loan modifications very difficult to sensibly achieve.